

Letter of Findings: 02-20150141 (Redacted)
Corporate Income Tax
For the Years 2010, 2011, and 2012

NOTICE: IC § 6-8.1-3-3.5 and [IC 4-22-7-7](#) require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Retail Stores was unable to establish that the Department's audit erred when it disallowed royalty expenses, interest expenses, and Net Operating Losses ("NOLs") in order to more fairly reflect Retail Stores' Indiana source income. Retail Stores was unable to establish that the inter-company royalty and loan obligations were entered into or undertaken for a primary purpose of other than to minimize Retail Stores' tax obligations.

ISSUES

I. Corporate Income Tax - Net Operating Loss Adjustments.

Authority: IC § 6-3-2-2(m); IC § 6-3-2-20; IC § 6-8.1-5-1(c); *Comm'r v. Transp. Trading & Terminal Corp.*, 176 F.2d 570 (2d Cir. 1949); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Enhanced Telecommunications Corp. v. Indiana Dep't of State Revenue*, 916 N.E.2d 313 (Ind. Tax Ct. 2009); *Monarch Beverage Co. v. Indiana Dep't of State Revenue*, 589 N.E.2d 1209 (Ind. Tax Ct. 1992); *Black's Law Dictionary* (7th ed. 1999).

Taxpayer argues that the Department exceeded its statutory authority in disallowing net operating losses ("NOLs") attributable to royalty and interest payments made to a related company and to disallow interest expenses paid to its out-of-state captive insurance company.

II. Tax Administration - Underpayment Penalty.

Authority: IC § 6-3-4-4.4(c); IC § 6-3-4-4.1(d); IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(2); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(d); [45 IAC 15-11-2\(b\)](#); [45 IAC 15-11-2\(c\)](#).

Taxpayer asks that the Department exercise its authority to abate a ten-percent "underpayment" penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state retail company which operates business locations inside and outside Indiana.

Taxpayer filed consolidated Indiana income tax returns. The Indiana Department of Revenue ("Department") reviewed Taxpayer and its associated companies' business records and its consolidated Indiana income tax returns for the tax years 2010, 2011, and 2012 ("Tax Years at Issue").

The Department's audit review made adjustments to Taxpayer's returns. The adjustments resulted in an assessment of additional income tax. Taxpayer disagreed with the adjustments and the resulting assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Corporate Income Tax - Net Operating Loss Adjustments.

DISCUSSION

This portion of the Letter of Findings addresses two separate but interrelated issues. The first issue is whether the

Department had the authority to effectively disallow NOLs attributable to royalty and interest expenses incurred by Taxpayer during prior years. The second issue is whether the Department was correct in disallowing interest expenses paid to its out-of-state captive insurance company.

A. Audit Findings.

There are three major parties affected by the Department's audit. The first party is Taxpayer which - as explained above - operates a chain of retail stores in Indiana and in other states.

The second party is an associated chain of retail stores here designated as "Related Chain Stores." Related Chain Stores was not included in Taxpayer's Indiana consolidated income tax returns.

The audit report explained the relationship between Taxpayer and Related Chain Stores:

[Related Chain Stores] is a 100[percent] owned subsidiary of [Taxpayer] and is effectively controlled by the parent, [Taxpayer].

The third party is Taxpayer's captive, self-insurance company headquartered at an out-of-state location and here designated as "Captive Insurer." Captive Insurer is a subsidiary of Related Chain Stores.

After reviewing Taxpayer's tax returns, financial records, and other business records, the audit found that Taxpayer and its subsidiaries earned "substantial income for federal tax purposes." However, "On a separate company basis, [Taxpayer] reported substantial net federal taxable losses." According to the audit report:

The consolidated return method used for Indiana income tax purposes has resulted in consistent losses for thirteen (13) years - 2000 to 2012. The Taxpayer has not paid Indiana adjusted gross income tax since 2003. Prior to 2003, the Taxpayer paid on [Indiana's] gross income tax.

The audit report concluded that - as reported in its tax returns and financial records - Taxpayer was effectively "insolvent."

Federal losses reported by [Taxpayer] (on a separate company basis) for thirteen years from FYE 1/31/2000 through 1/30/2012) caused its insolvency. [Taxpayer's] separate balance sheet shows a negative \$[redacted] billion net worth at the beginning of the audit period ballooning to a negative \$[redacted] billion net worth by the end. [Taxpayer] is reporting this large negative net worth while, overall, [t]he affiliated group is a financially healthy company.

The audit found that Taxpayer's "negative net worth means its liabilities exceed its assets (by \$[redacted] billion)" while "[i]ts account[s] payable alone exceeds its total assets by \$[redacted] billion (total assets of \$[redacted] billion versus accounts payable of \$[redacted] billion)." The audit found that - considering its substantial negative net worth - Taxpayer "would not be able to operate or survive as a going concern." However, the audit noted that despite its technical insolvency, Taxpayer "continued to buy back its own shares of stock . . . amounting to \$[redacted] billion and pay dividends to shareholders amounting to [more than \$[million]]."

Given the relationship between the parties, the audit found that "it [was] reasonable to conclude that [Taxpayer] operates as one economic entity with its affiliates." In arriving at its conclusion that Taxpayer and its affiliates shared a "unitary relationship," the audit found that the parties shared:

- Centralized functions such [as] treasury, financial accounting/reporting, legal, human resources, logistics/procurement, risk management;
- Inter-company loans, inter-company sales, inter-company services;
- Centralized management [with] common officers.

After considering the parties' relationship, various inter-company transactions, and the resulting distortion, the audit concluded that Taxpayer's Indiana adjusted gross income as reported on its Indiana tax returns did not "fairly reflect" Taxpayer's Indiana source income. The audit further considered alternatives to address the finding of distortion.

(1) Disallowing pre-2008 NOLs Attributed to Royalty and Interest Expenses.

The Department's audit considered requiring that Taxpayer and its affiliates file a combined return. However, Taxpayer requested that the Department "seek and explore an alternative to combination." In addition, Taxpayer proposed that the audit "add back" certain disputed royalty expenses claimed in prior years. According to the audit report, the effect of adding back the disputed royalty expenses would have to "eliminate[] nearly all of the net operating loss deductions in the audit period."

Nonetheless, the audit rejected Taxpayer's proposal to add back the royalties as "not sufficient to cure the distortion for the years under review." Taxpayer's proposal failed to address the interest expense deduction previously claimed. In discussions with Taxpayer's representatives, the audit proposed an alternative methodology.

As a compromise position with Taxpayer, a decision was made not to pursue the combination adjustment. Instead the net operating loss deduction from prior years partly resulting from royalty expense transactions was disallowed. The interest expense from [Captive Insurer] was also disallowed as an expense that is not [paid] on an arms-length basis. While these adjustments do not address all of the distortion of the Indiana adjusted gross income as reported, it remedies a substantial portion of such distortion.

(2) Disallowing Interest Expenses Paid to Related Chain Stores.

In previous years, Taxpayer developed certain intellectual property such as trademarks and trade names. Taxpayer transferred the intellectual property to Related Chain Stores. Thereafter, Related Chain Stores and Taxpayer thereafter entered into a licensing agreement allowing Taxpayer continued use of the intellectual property. Under the terms of the agreement, Taxpayer licensed back the intellectual property it had previously developed and owned. In return, Taxpayer paid Related Chain Stores royalties for the right to continued use of the intellectual property.

However, Related Chain Stores did not retain the royalties; Related Chain Stores then loaned the royalties back to Taxpayer. Because the royalties are on loan, Taxpayer also paid Related Chain Stores interest and deducted the interest expenses. As outlined in the audit report:

The audit showed that [T]axpayer incurs substantial royalty expenses under the terms of the royalty agreement. The proceeds of the royalty payments are being loaned back to [Taxpayer]. [Taxpayer] incurs both the royalty and interest expenses to [Related Chain Stores].

In addition, the audit report further explained:

The increasing account balance of "Other Investments" indicates the royalty payments and the interest on the loan back are not being collected in cash. The interest on the loan is being added to principal to generate more interest income.

The audit required that Taxpayer add back both the deductions for royalties and interest. The audit did so under authority of IC § 6-3-2-20 and IC § 6-3-2-2(m). Although the audit indicated that it was barred by the statute of limitations from assessing additional tax in all prior years, it was permitted to make the NOL adjustments "to arrive at the accurate net operating losses available to carry into the current audit years." The audit's NOL adjustments resulted in the assessment of 2010, 2011, and 2012 Indiana income tax.

(3) Disallowing Interest Expenses Paid to Captive Insurer.

In 2001, Taxpayer established a self-insurance program to protect itself against substantial property and other losses. To that end, Taxpayer organized and established Captive Insurer. Captive Insurer was organized as a subsidiary of Related Chain Stores.

A captive insurer is defined as "[a] company that insures the liabilities of its owner. The insured is [usually] the share holder and only customer of the captive insurer." Black's Law Dictionary 808 (7th ed. 1999).

Under the laws of the state in which Captive Insurer was organized, Related Chain Stores was required to provide Captive Insurer \$[redacted] billion dollars in capital. Related Chain Stores did so in [redacted] by transferring Captive Insurer "notes receivable." The notes receivable consisted of loans made by Related Chain Stores to Taxpayer.

The audit found that there was a relationship between the royalties Taxpayer paid to Related Chain Stores and the notes receivable. As explained in the audit report:

It appears that substantially, if not all of such loan came from the proceeds of the royalty and related interest charges which were loaned back to [Taxpayer] by [Related Chain Stores]. [Taxpayer] was charged about \$[redacted] million a year in royalty and interest payment[s] to [Taxpayer] starting the date the license agreement was signed. Approximately four years later, (the incorporation date of [Captive Insurer]), such royalty proceeds and the accumulated interest income on such proceeds would approximate the amount of the promissory note if not more.

The audit disallowed the interest expenses charges paid Captive Insurer on the ground that the terms of the agreement transferring the notes receivable (worth \$[redacted] billion) and the subsequent interest charges were not entered into "on an arm's length basis." The audit found that the notes did not have a maturity date. As specified in the promissory note, "Interest and principal shall be payable in full upon demand."

The audit report noted that the promissory note had the wrong payee/lender. The note specified that the lender was Captive Insurer while the renewal note indicated that Related Chain Stores was the payee/lender but the interest payments were made to Captive Insurer. As explained in the audit report, "[Related Chain Stores] is the lender in the original note but such note has since been conveyed to [Captive Insurer]."

The audit report found that no payments on the principal have been made since 2001.

The audit concluded that there was no apparent intention of ever paying the principal. As provided in the audit report, "It appears the Payee can unilaterally extend the due date of the promissory note and the Maker waives it[s] right to have a say on whether to extend or postpone the due date of the promissory note." The promissory note states:

[The parties] consent to any extension or postponement of time of payment of this Note and to any such indulgence with respect hereto without notice thereof to any of them.

The audit report states that the loan arrangement between Related Chain Stores and Captive Insurer was "lopsided" and that was no "incentive for the Maker to prepay the note. This arrangement creates deductible interest expense for [Taxpayer] which decreases state income tax exposure of the Maker among the [multiple] separate-return states [in] which it does business."

In considering the nature of the interest expenses, the audit reviewed Taxpayer and Captive Insurer's bank records. In one instance, Captive Insurer's bank records documented a payment by Taxpayer of approximately \$[redacted] million in interest charges. On the same date the payment was made, Captive Insurer's account was debited for approximately \$[redacted] million. When questioned about this particular transaction, Taxpayer explained:

The entry on [Captive Insurer's] book was a debit to the revolving credit note and a credit to cash. The transfer is to [Taxpayer] as part of the revolving credit agreement

In response to the "revolving credit" arrangement, the audit found that:

While the Taxpayer made a wire transfer to pay the interest, such payment was loaned back to [Taxpayer] in a flash transaction through its revolving account payable with [Captive Insurer]. The revolving account also earns interest and has no maturity date. This transaction has the same effect as not collecting the interest in cash and instead adding it to another interest bearing receivable account.

B. Taxpayer's Response.

Taxpayer disagreed with the Department NOL adjustments and also disagrees with the disallowance of interest expense paid Captive Insurer.

(1) NOL Adjustments.

Taxpayer disagreed with the adjustment of its NOLs attributable to the add back (disallowance) of royalty and related interest expenses. Taxpayer explains:

The majority of the NOLs used to offset taxable income for these periods arose prior to fiscal year ending February 3, 2007 and arose from royalty and interest payment made to [Related Chain Stores].

Taxpayer explains the relevance of the "February 3, 2007" reference to its statutory argument. Taxpayer cites to IC § 6-3-2-20 as granting the Department authority requiring Taxpayer to add back the interest and royalty expenses. However, Taxpayer states that IC § 6-3-2-20 was effective only after June 30, 2006, and did not require Taxpayer to add back the expenses prior to that date. Taxpayer explains that implementation of IC § 6-3-2-20 affected Taxpayer's beginning with its tax year ending February 2008 and that Taxpayer "complied with the law and added back to income the intangible expenses and directly related intangible interest expense beginning that tax year."

Taxpayer concludes that the Department was without authority to adjust the NOLs because the "Indiana legislature did not enact a law disallowing the deduction of [the] licensing agreement until 2006, effective for tax years beginning after June 30, 2006, and the law did not require adjustment retroactive to prior tax years."

The auditor's retroactive adjustment of these [NOLs] is contrary to the intent of the Indiana legislature and is inconsistent with the fact that the legislature felt it needed to enact a law in 2006 applicable prospectively to tax years beginning after June 30, 2006.

(2) Interest Expenses Paid to Captive Insurer.

Taxpayer explains that it established Captive Insurer predicting substantial increases in the cost of commercial property insurance and "to achieve the financial and risk management advantages from operating a well-regulated captive insurance company." Taxpayer further explains that by forming Captive Insurer, it "was able manage cash flow, obtain tailored coverage, and have direct access to reinsurers."

Taxpayer states that it was required by the out-of-state insurance regulator to capitalize Captive Insurer and that \$[redacted] billion was the minimum amount necessary to meet that capitalization requirement.

Taxpayer argues that the "auditor misrepresented the facts regarding the substantive business capitalization of [Captive Insurer]." Taxpayer states:

- Related Chain Stores is not an "intangible holding company;"
- There is only one note between Captive Insurer and Taxpayer which does not have a maturity date, that promissory notes contributed to Captive Insurer by Related Chain Stores contained 2010 and 2011 maturity dates, but that the notes were renewed and now contain 2020 and 2021 maturity dates;
- The fact that no principal has been paid on any of the notes is irrelevant because "the notes have a demand feature and all principal must be paid on demand."
- Captive Insurer's day-to-day operating expenses are paid out of the interest payments made to Captive Insurer;
- Captive Insurer has been audited by the Internal Revenue Service and "determined to be an insurance company for federal taxation purposes," is "regulated by the state of [redacted]," and "pays premium taxes to the state of [redacted];"
- Captive Insurer's interest income is paid pursuant to a "legitimate business purpose and does not distort [T]axpayer's income from the operational side of Taxpayer's business;"
- Taxpayer did not make its decision to establish Captive Insurer with the purpose of avoiding Indiana income tax.

C. Hearing Analysis.

In considering Taxpayer's protest and as a threshold issue, it is the Taxpayer's responsibility to establish that the audit decision disallowing the interest and royalty expenses and the consequent tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East*,

Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to an agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, interpretations of Indiana tax law contained within this administrative decision, as well as the preceding audit, are entitled to deference.

(1) IC § 6-3-2-20.

Taxpayer discounts the audit's reliance on IC § 6-3-2-20 which provides in part:

Except as provided in subsection (c), in determining its adjusted gross income under [IC 6-3-1-3.5\(b\)](#), a corporation subject to the tax imposed by [IC 6-3-2-1](#) shall add to its taxable income under Section 63 of the Internal Revenue Code:

- (1) intangible expenses; and
- (2) any directly related intangible interest expenses; paid, accrued, or incurred with one (1) or more members of the same affiliated group or with one (1) or more foreign corporations. IC § 6-3-2-20(b).

Taxpayer contends that the addback provision was only effective for tax years after June 30, 2006, and that - as a result - the audit lacked the statutory authority to disallow NOLs attributable to the royalty and interest expenses at issue.

As previously explained, the audit did rely upon IC § 6-3-2-20 to make adjustments to the audit years. The audit acknowledged that the statute of limitations barred an assessment of additional tax in the years prior to the audit years, however, there is no restriction in relying on IC § 6-3-2-20 to make the NOL adjustments for the years subject to the audit. Therefore, there is no restriction regarding the application of IC § 6-3-2-20 to make adjustments to Taxpayer's tax liabilities during the audit years.

(2) Fairly Reflecting Taxpayer's Income Pursuant to IC § 6-3-2-2(m).

In addition to relying upon IC § 6-3-2-20 to adjust Taxpayer's Indiana sourced income for the audit years, the audit also relied on the "fairly reflect" provision contained in IC § 6-3-2-2(m) to justify the audit results and subsequent proposed assessments. IC § 6-3-2-2(m) provides:

In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers. (Emphasis added).

Before proceeding, it is worth a brief discussion regarding the meaning of this subsection of IC § 6-3-2-2. Based on the plain language of the statute, the Indiana Legislature has granted the Department the authority to "distribute, apportion, or allocate" taxpayer income that is derived from sources within Indiana in order to fairly reflect taxpayer's income. It is important to note that the statute states that the Department "shall" fairly reflect taxpayer income. In other words, the Department is required to fairly reflect taxpayer income that is sourced to Indiana. Additionally, the plain language of the statute does not include any other standard other than the Department's distribution, reapportionment, or allocation must fairly reflect the taxpayer's Indiana income. To graft any other standard into the statute that is not identified in the plain language of the statute would violate the legislature's intent, as well as the guidance set forth by the Indiana Supreme Court. See Caterpillar, 15 N.E.3d at 583-86.

As noted above, the audit raised the issue whether - as reported - Taxpayer's Indiana returns accurately reflected Taxpayer's business activities in Indiana. Ultimately, the audit concluded that Taxpayer should be subject to an alternate allocation, apportionment, or distribution of its Indiana source income in order to more fairly reflect that income. Thus, the question that must be determined for purposes of this administrative decision is whether the Taxpayer's returns distorted (i.e., did not fairly reflect) the Taxpayer's actual Indiana sourced income.

The determination as to whether the Taxpayer's Indiana sourced income - as reported - fairly reflected the Taxpayer's Indiana sourced income, requires a review of the Taxpayer's various transactions to determine if the

transactions were conducted in such a way as to distort the Taxpayer's Indiana business activity. In other words, did the form of the Taxpayer's business, as the Taxpayer presented to the Department, fail to reflect the substance of the Taxpayer's actual business. See *Monarch Beverage Co. v. Indiana Dep't of State Revenue*, 589 N.E.2d 1209, 1215 (Ind. Tax Ct. 1992) (stating that Indiana determines tax consequences based on the substance of a transaction, not its form) (although the Monarch decision pertained to use tax, the form over substance concept has been applied to other taxing schemes, such as the Utility Receipts Tax in *Enhanced Telecommunications Corp. v. Indiana Dep't of State Revenue*, 916 N.E.2d 313 (Ind. Tax Ct. 2009)).

Some of the pertinent facts to consider in this matter include the fact that the structure of the Taxpayer's business has resulted in the Taxpayer not paying Indiana income tax since 2003 despite having received in excess of \$[redacted] billion dollars in Indiana gross receipts during approximately ten years. Further, as reported, Taxpayer's business records establish that Taxpayer was technically "insolvent" holding a \$[redacted] billion dollar "negative net worth" with its accounts payable exceeding its total assets by \$[redacted] billion. The audit was correct in regarding its reported financial status as anomalous when Taxpayer was able to buy back its own stock worth in excess of \$[redacted] billion and while simultaneously paying its shareholders dividends exceeding \$[redacted] million.

The audit attributed Taxpayer's reported financial status to royalty and related interest expenses stemming from its licensing agreement with Related Chain Stores. The audit justifiably questioned whether any rational business purpose underlay an arrangement by which Taxpayer essentially was paying Related Chain Stores in excess of \$[redacted] million dollars each year for the right to use trademarks and trade names which were developed by Taxpayer especially when the substantial royalty payments were immediately "loaned back" to Taxpayer. Having loaned these amounts back to Taxpayer, the audit was equally justified in questioning the business purpose of paying interest expenses attributable to those same loans especially given the amount of those interest expenses which ranged from approximately \$[redacted] to \$[redacted] million each year.

On their face, the form of the Taxpayer's royalty and interest expenses seem entirely self-serving and represent transactions which seem to be generated out of thin air. Moreover, the Department questions whether the interest payments stem from a truly arm's length transaction when there appears to be little or no evidence that Taxpayer intends to ever pay back the principal. The Department question whether the interest expense thereafter incurred by Taxpayer are anything more than the insubstantial "flash transactions" simply added to yet another "receivables account." In other words, the form and structure of the Taxpayer's business, which created a non-viable business by means of royalty and interest expense payments, did not reflect the substance of the Taxpayer's actual Indiana business and profitability.

Similarly, Taxpayer's explanation for deciding to self-insure its various real and intangible assets appears to have the form of a valid business decision. However, the Department notes the fact that the means by which Taxpayer capitalized the Captive Insurer consisted of notes receivable from the proceeds of the same royalty and interest charges which had been loaned back to Taxpayer by Related Chain Stores. As such, the form of the Taxpayer's business has created a circular flow of monies that causes the business to be indefinitely insolvent and ensures that Taxpayer's business activities are never fairly reflected within Indiana. As it is reasonable to assume that a company would prefer to remain in business, rather than be insolvent, it is clear that Taxpayer's business structure lacks a substantive business purpose and the audit adjustments were appropriate under IC § 6-3-2-2(m).

Considering Taxpayer's objections and the audit's stance on these matters, it is appropriate here to note that Taxpayer is under no obligation to manage its business arrangements to maximize its tax liability. As noted in *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." However, it should also be noted that in the Supreme Court decision *Gregory v. Helvering*, 293 U.S. 465 (1935), challenging the previously cited decision, the Court stated that in order to qualify for favorable tax treatment, a business reorganization must be motivated by the furtherance of a legitimate corporate business purpose. *Id.* at 469. A business activity undertaken merely for the purpose of avoiding taxes was without substance and "to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." *Id.* at 470.

The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial or industrial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." *Comm'r v. Transp. Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949), cert. denied, 338 U.S. 955 (1950).

Although the form and structure of Taxpayer's business could be construed as technically valid, the Indiana Tax Court requires that the Department consider the substance of the business transactions to determine whether Taxpayer's Indiana returns fairly reflect its business activities in the State. Based on a review of the facts and Taxpayer's business structure as a whole, the Department is unable to agree that Taxpayer has met its burden under IC § 6-8.1-5-1(c) of establishing that the assessment was "wrong" or that the various transactions and obligations here at issue were entered into or undertaken for a purpose other than to minimize its Indiana tax obligations.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration - Underpayment Penalty.

DISCUSSION

Taxpayer objects to the Department's imposition of a ten-percent underpayment penalty on the ground that it "was acting in good faith, exercising ordinary care and prudence."

IC § 6-3-4-4.4(c) imposes on each taxpayer the responsibility to calculate and pay a "declaration of estimated tax for the taxable years" if the amount of that estimated is more than \$1,000. *Id.*

Every corporation subject to the adjusted gross income tax liability imposed by this article shall be required to report and pay an estimated tax equal to the lesser of:

- (1) twenty-five percent (25[percent]) of such corporation's estimated adjusted gross income tax liability for the taxable year; or
- (2) the annualized income installment calculated in the manner provided by Section 6655(e) of the Internal Revenue Code as applied to the corporation's liability for adjusted gross income tax.

IC § 6-3-4-4.1(d) imposes a penalty if a taxpayer fails to pay the correct amount of estimated tax.

The penalty prescribed by [IC 6-8.1-10-2.1\(b\)](#) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:

- (1) the annualized income installment calculated under subsection (c); or
- (2) twenty-five percent (25[percent]) of the final tax liability for the taxpayer's previous taxable year. *Id.*

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the under-estimate results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(2) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to . . . pay the full amount of tax shown on the person's return . . . or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty."

Departmental regulation [45 IAC 15-11-2\(b\)](#) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." *Id.*

Departmental regulation [45 IAC 15-11-2\(c\)](#) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed"

Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment - including the underpayment penalty - is presumptively valid.

Taxpayer believes it is entitled to abatement of the penalty; the Department does not agree. Taxpayer is a substantial, sophisticated retailer with a presence in this state. Taxpayer has arranged and managed its business affairs and transactions as to avoid paying Indiana income tax since 2003 while simultaneously enjoying the benefits provided this state and enjoying access to millions of Indiana customers. These benefits are the means

by which it prospered, expanded, and earned significant amounts of income from the residents of this state.

Based on a consideration of the relevant "facts and circumstances," Taxpayer has not met its burden of establishing that the penalty should be abated.

FINDING

Taxpayer's protest is respectfully denied.

Posted: 01/27/2016 by Legislative Services Agency
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